

Internal Audit Correspondence

Audit:	Cap Ex
Date:	6/12/02
Participants:	Max Bobbit, Cynthia Cooper, Glyn Smith
Method of Communication:	Telephone Call from Cooper office Bldg 4, Floor 3

Cynthia Cooper and Glyn Smith telephoned Max Bobbit to discuss issues surrounding the Capitalization of Line Costs under the description "Prepaid Capacity." Cynthia briefed Max on the communications with San Jeev Sethi, Mark Abide, David Myers and Scott Sullivan.

Cynthia described the timing and amounts of the journal entries, discovered to date, related to Prepaid Capacity including:

- \$743M in 3Q01
- \$941M in 4Q01
- \$818M in 1Q02

These entries total \$2.5B. Cynthia also discussed an additional \$115M in reductions to depreciation expense which was part of these entries and \$600M of unrelated Cap Ex additions, both of which audit is still researching.

Glyn related the following key points from the 6/11/02 meeting with Scott Sullivan:

- Scott asked Audit to delay the current review until 3Q02 and to audit the 2Q02 numbers.
- Scott noted there were several Cap Ex issues which needed to be cleared up in 2Q02.
- When asked by Cynthia to explain Prepaid Capacity Costs, Scott indicated that while revenues had declined, the costs related to certain leases were fixed creating a matching problem. He stated Prepaid Capacity represented costs associated with no or low utilized Sonet Rings and lines which are being capitalized.
- Scott indicated this treatment of line costs started in 3Q01 and continued through 1Q02. Previously, these costs had been expensed.
- Scott indicated that going forward, these costs would either be expensed or recognized as a restructuring charge.
- Scott indicated that this and other Capitalization issues would be corrected in 2Q02.

Cynthia also noted that Scott stated that the Company will no longer capitalize line cost labor going forward.

Cynthia indicated Audit's plans were to:

- Continue with the audit
- Meet with Ferrell Malone, KPMG, to determine if their were standards supporting these entries
- Review AA workpapers related to Cap Ex
- Request supporting documentation for these entries from David Myers.

Max asked Cynthia to discuss these issues with Ferrell Malone, KPMG, before the 6/14/02 Audit Committee Meeting. Cynthia noted that Audit had previously met with Ferrell to discuss these issues based on research completed at that time (6/5/02) and plans to meet with Ferrell again in the afternoon (6/12/02) to update him on research completed to date. Max stated the matter would be discussed in the Executive Session of the AC meeting with Ferrell and Cynthia present.

Max then asked Cynthia to refrain from discussing this matter with David Myers or Scott Sullivan until a consensus is reached at the Audit Committee Meeting on how to proceed.